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No. 85-182

In the Supreme Court of the United States

OCTOBER TERM, 1985

NORTHWEST CENTRAL PIPELINE CORPORATION, ET AL.,
APPELLANTS

v.

CORPORATION COMMISSION OF KANSAS, ET AL.

ON APPEAL FROM THE SUPREME COURT OF KANSAS

BRIEF FOR THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION AS AMICI CURIAE

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QUESTION PRESENTED

Whether the order of the Kansas Corporation Commission regulating the quantity of gas that may be produced from Kansas gas wells impermissibly interferes with the federal regulatory scheme established by the Natural Gas Act, 15 U.S.C. 717, *et seq.*, or exceeds the State's power under the Commerce Clause of the United States Constitution.

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This brief is filed in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Like other gas producing states, Kansas has laws "to prevent the inequitable or unfair taking of natural gas," Kan. Stat. Ann. § 55-703 (1983) (set forth as J.S. App. 99a-101a). One reason for these laws is that gas can migrate underground, from

underproduced areas of higher pressure to produced areas of lower pressure. Thus, it is theoretically possible to extract from a single well or group of wells all of the recoverable natural gas in the field, exhausting the unproductive or less productive wells (J.S. App. 5a-6a).

With a recent modification we shall describe, the Kansas Corporation Commission (Kansas Commission) has implemented state law since 1944 so that each gas well in the Hugoton Field [1] may "ultimately produce approximately the amount of gas underlying the lease upon which it is located." Basic Proration Order for the Hugoton Gas Field 12-13 (13 R. 37-38). Under these regulations, the Kansas Commission sets "allowables" for the Hugoton field—*i.e.*, gas production ceilings that assign to each producer the maximum amount of gas that may be produced from each well per month.

The rules are thus designed to spread market demand over all producing wells in proportion to their production capability. In practice, however, the wells cannot always meet their monthly allowables—a well may be "shut in" because of mechanical problems or the lack of a willing buyer of the gas, or it may voluntarily under- or overproduce. Consequently, the Kansas scheme uses production tolerances to account for under- or overproduction. If a well produces less than its allowable, it accrues an "underage," measured as the difference between its allowable and its actual production; in the same way, an overproducing well accrues "overages." Both underages and

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[1] The Hugoton field extends across portions of Kansas, Oklahoma and Texas. About two thirds of the field is located in Kansas; that portion of the field contained more than 4,000 wells in 1983 (J.S. 3).

overages can be offset against future allowable levels. For example, a well can exceed its allowable by the amount of its underage if there is a purchaser for the extra gas and the well can physically produce it.

2. In February 1983, the Kansas Commission changed the underage rules to create "an incentive to operators to produce" (J.S. App. 62a).[2] The 1983 change provided, for the first time, that underages would be permanently cancelled if the producer did not reinstate[3] the underage by a certain time or, if reinstated, the underage was not produced within 5 years (J.S. App. 8a-9a). By its express terms, the rule change was "directed to and affects only those who drill for and produce gas from the Hugoton field. * * * [It] does not require pipeline[ ] purchasers to do anything or refrain from doing anything" (J.S. App. 75a).

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[2] For most wells in the Hugoton field, underages had risen dramatically in recent years, reaching over 204 billion cubic feet of gas by 1982 (J. S. App. 62a), when the total natural gas production for all of Kansas in 1982 was a little over 430 billion cubic feet (American Gas Association, *Gas Facts: 1984 Data* 28, 29 (1985)). The Kansas Commission found that this high underage level stemmed from the fact that pipelines were not willing to purchase the gas up to the allowable levels. Because of relatively liberal production and sales contracting terms and the higher tolerances for underproduction in the Kansas Hugoton field, pipelines were using that field for "storage" and filling their gas needs elsewhere first (J.S. App. 22a).

[3] The state regulations provide that if a well accumulates underages equal to six times its monthly allowable, the underages are cancelled. Until the 1983 amendment, such "cancelled underages" could be reinstated at any time that the well was in an overproduced status and had a ready purchaser (J.S. 5).

3. Appellants, with other interstate pipelines, participated before the Kansas Commission in the rulemaking preceding the rule change. They challenged the proposed rule change on the ground (inter alia) that it would unlawfully encroach upon the federal government's exclusive regulatory jurisdiction under the Natural Gas Act, 15 U.S.C. 717 *et seq.*[4] Appellants argued that cancelling underages would force them to purchase more Kansas gas at a time when they did not need the gas, and therefore that the state was in effect directing their purchasing practices, a matter exclusively the concern of the Federal Energy Regulatory Commission. See *Northern Natural Gas Co.* v. *State Corporation Commission*, 372 U.S. 84 (1963).

After the Kansas Commission rejected these contentions, appellants sought judicial review of the new rule. The Kansas district court upheld the new rule (J.S. App. 41a-48a) on the theory that it involved the "production or gathering" of gas, and thus was a legitimate state act specifically excluded from the ambit of federal regulation by Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b).

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[4] Most of the natural gas produced from the Kansas-Hugoton gas field is produced for and sold to interstate gas pipelines under certificates of public convenience and necessity issued by the Federal Power Commission (now the Federal Energy Regulatory Commission) under the Natural Gas Act (J.S. 3-4). This means that the gas is dedicated to interstate commerce and producers have a legal duty to sell their gas to the interstate market until relieved of that obligation by the Commission. Passage of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3301 *et seq.*, did not relieve producers from that obligation, because that Act specifically provides that gas flowing in interstate commerce before the NGPA was enacted generally remains under the Commission's Natural Gas Act authority (15 U.S.C. 3431(a)).

A divided Kansas Supreme Court affirmed (J.S. App. 4a-32a). While recognizing that the new rule had an "indirect effect to influence purchasers" and "even though purchasers are indirectly caught in the backwash," the majority upheld the rule against the challenge based on *Northern Natural* because the "rules on underages are a part of production regulation" over which the state has exclusive jurisdiction (J.S. App. 28a-29a). In dissent, Chief Judge Schroeder was of the view that the rule must fall, either on the ground that the Kansas Commission had exceeded its "statutory authority in fixing allowables far in excess of demand" (J.S. App. 33a), or alternatively, because the state regulation violated *Northern Natural*: while "directed at producers not purchasers, its real purpose is to create an impact on purchasers' business decisions concerning the makeup of their interstate gas mix" and therefore its effect is to impair the regulatory authority of the Commission under the Natural Gas Act (J.S. App. 34a-36a).

DISCUSSION

In *Northern Natural* this Court set aside state orders directing interstate gas pipelines to take gas ratably from Kansas wells under penalty of state law. In so ruling, the Court found that those orders "necessarily deal[t] with matters which directly affect the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sales of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act." 372 U.S. at 91-92. In that case, interstate pipelines had been directed, under the threat of state imposed criminal sanctions, to change their purchasing practices to balance the out-

put of the state's wells. In that situation, the Court concluded that "although collision between the state and federal regulation may not be an inevitable consequence, there lurks such imminent possibility of collision in orders purposely directed at interstate wholesale purchasers that the orders must be declared a nullity in order to assure the effectuation of the comprehensive federal regulation ordained by Congress." 372 U.S. at 92.

The question of the continuing validity of *Northern Natural* is currently before this Court in *Transcontinental Gas Pipe Line Corporation* v. *State Oil and Gas Board of Mississippi (Transco)*, No. 84-1076 (argued Oct. 8, 1985). We there argued that *Northern Natural* has continued validity in today's natural gas regulatory system. This case, unlike *Northern Natural* and *Transco*, involves a state order directed at the gas producers, rather than their purchasers. If we are correct in our contention in *Transco*, the question remains whether this difference in the state order serves to avoid the preemptive effect of the federal scheme.

1. The state courts believed that it did. In holding that *Northern Natural* has no application to the Kansas Commission's rule change, the state courts deemed the dispositive consideration to be that the rules here at issue, even though "obviously intended for purchasers," are in terms "directed to producers" and thus constitute a lawful exercise of legitimate state authority over the "production or gathering of natural gas" (J.S. App. 28a-29a). In reaching this conclusion, the state courts thus apparently view *Northern Natural* as having drawn a bright line between the federal and state regulatory interests based on whether the state action addresses purchasers or producers.

At first blush, this is an inviting approach. State control over the production of mineral resources is, as long recognized by the Court, an important aspect of state authority not to be overturned on preemption grounds absent the establishment of a legitimate federal purpose.[5] See, *eg.*, *Champlin Refining Co.* v. *Corporation Commission*, 286 U.S. 210, 235 (1932) and cases there cited (upholding state proration orders applying only to the production and not to the sales or transportation of crude oil); see also *Thompson* v. *Consolidated Gas Utilities Corp.*, 300 U.S. 55, 69 (1937) (discussing the state's "undoubted power" to regulate gas production to prevent waste, and to create and protect correlative rights of owners of a common pool of gas against drainage). Indeed, in *Northern Natural* itself this Court recognized a "significant distinction" between "measures aimed directly at interstate purchasers and wholesale[r]s for resale [which are unlawful], and those aimed at producers and production" (372 U.S. at 94). The Natural Gas Act similarly recognizes this distinction in exempting from federal jurisdiction gas "production or gathering" (15 U.S.C. 717(b)).[6]

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[5] We do not agree with appellants' suggestion (J.S. 13-14) that the rule change cannot reasonably be viewed as designed to affect the conduct of producers, because they need no incentive to produce and sell gas. It would not have been unreasonable for the State Commission to conclude that under the original system, producers might prefer to postpone sales in the hope they would obtain a higher price for their product in the future.

[6] Appellants incorrectly suggest (J.S. 15 n.3) that a state's "production or gathering" authority under Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), covers only physical activities such as gas well drilling, spacing and the like. See *Northern Natural*, 372 U.S. at 90; see also *Shell Oil Co.*

2. But, as this Court recognized in *Northern Natural*, the purposes underlying preemption in this area do not in fact permit such a simple, "bright line" analysis. Instead, as the Court there explained (372 U.S. at 91-92 (footnote and citation omitted)):

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v. *FERC*, 566 F.2d 536 (5th Cir. 1978), aff'd by an equally divided Court, 440 U.S. 192 (1979). The state rule here, which on its face is part of the state's general proration scheme ordering when and how gas can be produced (J.S. App. 51a), appears to fit squarely within the recognized area of regulation over the physical production of gas—*i.e.*, it determines how allowables may be exceeded at a given time to make up underages. Such state regulation through proration rules has long been viewed as regulating "production," not sales or transporation. *See Champlin Refining Co.* v. *Corporation Commission*, 286 U.S. 210, 235 (1932) (state proration rules impose no impermissible burden on interstate commerce). *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1965), upon which appellants rely, is not to the contrary. That case involved transactions the Court found to be "sale[s] of natural gas in interstate commerce" (381 U.S. at 402). It did not redefine the mutually exclusive spheres of state and federal jurisdiction demarked by the "production or gathering" exclusion of Section 1(b). Indeed, the Court's decision recognized that demarcation in noting that its decision "in no way interfer[ed] with state regulatory power over the physical processes of production or gathering in furtherance of conservation or other legitimate state concerns" (381 U.S. at 403).

The passage of the Natural Gas Policy Act did not alter this basic demarcation. As the legislative history of the NGPA makes clear, its passage "does not contemplate that FERC will intrude into the traditional conservation functions performed by the states * * * who, in the exercise of their historical powers, will continue to regulate such matters as drilling locations, completion techniques, *production rates*, etc." (124 Cong. Rec. 38366 (1978) (remarks of Rep. Dingell, House Manager of the NGPA) (emphasis added)).

> [t]he federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, * * * or for state regulations which would indirectly achieve the same result. * * * [S]tate orders [that] necessarily deal with matters which directly affect the ability of the Federal Power Commission [now the Federal Energy Regulatory Commission] to regulate comprehensively and effectively the transportation and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act * * * invalidly invade the federal agency's exclusive domain.

Appellants argue that the Kansas orders here are as inconsistent with federal regulation of interstate gas pipelines as the state scheme ruled invalid in *Northern Natural*, because the Kansas orders are designed to compel interstate pipelines to increase their takes of Kansas gas or lose forever their right to take such gas in the future (J.S. 7-8). Appellants contend that if they increase their Kansas takes, they must reduce their purchases from other producers, thereby incurring take-or-pay liability for the gas not taken and burdening their interstate customers with these added costs (J.S. 9, 16-18). On the other horn of the dilemma, they claim that if the gas is not taken now, their producers' underages could be permanently cancelled and gas originally destined for the interstate gas market customers could then effectively be diverted from appellants through drainage (J.S. 7 n.2). In sum, appellants' preemption claim rests on the assertion that interstate pipelines that exercise their contractual right to delay purchasing volumes of gas committed to them by their producers will lose the opportunity to buy that gas later (J.S. 16-18).

If appellants are correct, the state action cannot, we submit, stand under established preemption doctrine. As in *Northern Natural* the pipelines would effectively be required, under compulsion of state law, to change their purchasing practices to fit the parochial preferences of the state. This is the same conflict—or real possibility of conflict—between the state and federal schemes that required an otherwise valid state scheme to give way in *Northern Natural*, 372 U.S. at 94.[7] In such circumstances, it cannot be dispositive that the regulatory language used by the state is directed at gas production and producers. The inquiry instead must be whether the state action interferes with the federal scheme, no matter whether that interference is effectuated directly or indirectly.

Nor is it enough to save the state scheme merely to show that the challenged regulation serves a valid state interest. As this Court recognized in *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 584 (1981) (citation omitted):

> [e]very pre-emption case involves a conflict between a claim of right under federal law and a claim of right under state law. A finding that

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[7] Indeed, if the state's order would result in drainage of gas dedicated to interstate commerce (J.S. 7 n.2, 18-19), this would raise serious questions affecting the Federal Energy Regulatory Commission's authority apart from any consideration of pipeline purchasing practices (Gov't Br. at 12, *Transco*). Gas that is dedicated to interstate commerce may not be diverted from that commerce without Commission "abandonment" authorization under Section 7(b) of the Natural Gas Act, 15 U.S.C. 717f(b). See generally *United Gas Pipe Line Co.* v. *McCombs*, 442 U.S. 529, 542 (1979); *California* v. *Southland Royalty Co.*, 436 U.S. 519, 525-526 (1978); *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 156 (1960).

> federal law provides a shield for the challenged conduct will almost always leave the state-law violation unredressed. * * * "[S]ince remedies form an ingredient of any integrated scheme of regulation * * * to allow the State to grant a remedy here which has been withheld [in the federal regulatory scheme] only accentuates the danger of conflict."
>
> The same principle applies here. * * * No appeal to equitable principles can justify [the] usurpation of federal authority.

3. This case should be disposed of in light of this Court's decision in *Transco*. If the Court rejects our contentions in that case, it may so limit *Northern Natural* that the result reached by the courts below would clearly be correct. Otherwise, this case should be remanded to the State Supreme Court for additional findings and analysis. As we have explained, the courts below incorrectly read *Northern Natural* as providing a "bright line" test depending simply on whether the state regulation directly addresses interstate purchasers. This Court's decision in *Transco* will undoubtedly shed further light on this issue, and it is appropriate for the state courts to grapple in the first instance with the application of the principles to be laid down in *Transco* to the somewhat different facts of this case.

Moreover, neither the Kansas Commission nor the Kansas courts made findings that could be highly pertinent to the correct resolution of this case. We submit that the state may not lawfully compel interstate pipelines, on pain of suffering a legal or economic penalty, to become unwilling partners with Kansas in requiring increased production of Kansas gas. The record would arguably support a finding that the state rule change had an impermissible coercive effect on the pipelines—in this case, that they should change

their purchasing practices or risk forfeiting the right to purchase gas in the future.[8] Since neither the Kansas Commission nor the Kansas courts made such a finding,[9] however, it would not be appropriate

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[8] For example, while there was testimony before the Kansas Commission that the rule change would cause a loss of gas reserves (see, *e.g.*, 13 R. 544-547 (summarizing testimony)), but there was also contrary testimony (see 10 R. 179-180). The Kansas Commission's own expert testified on both sides of the question, declaring that cancelling underages would not mean losing reserves (9 R. 53) but might result in drainage (9 R. 86). There is no suggestion that the pipelines would forfeit gas that was already paid for; the controversy concerns only contractual rights to make future purchases.

[9] The only finding describing the effect of the rule change on the pipeline purchasers is that of the district court (J.S. App. 46a):

> [a]s a practical matter, the [rule] change * * * will cause some permanent loss of underages (allowables) due to market conditions and will also cause a change in the "mix" of natural gas which pipelines transport for sale many miles away.

The court leaves unanswered, however, the question whether the change in the pipelines' gas "mix" would result from pipelines being forced to purchase Kansas gas under the risk of losing contractual rights to take that gas at a future time. As the Kansas Supreme Court observed, the district court found "that the order would induce increased production" (J.S. App. 27a). Yet, there is no explanation of how or why this would happen.

Although appellants state (J.S. 7 n.2) that "it is clear that [loss of reserves] will occur with respect to a signficant number of wells in the Hugoton Field," their authority for this statement is simply a citation to those parts of the Kansas Supreme Court's opinion that summarize the appellants' contentions and their evidence; that court specifically declined to make any such finding, deferring instead to the Kansas Commission as the expert body. The dissent, also quoted by appellants, did not ground its conclusion regarding uncompensated drainage on any findings below. Compare J.S. App.

for this Court to atempt to make a finding concerning the effects of the rule change on the pipelines. It should instead, we submit, remand to the Kansas Supreme Court with directions that findings be made as to the effect of the rule.

This Court has made clear that "The exercise of federal supremacy is not lightly to be presumed." *New York Department of Social Services* v. *Dublino*, 413 U.S. 405, 413 (1973) (quoting *Schwartz* v. *Texas*, 344 U.S. 199, 202-203 (1952)); see also *Pacific Gas & Electric Co.* v. *State Energy Reserves Conservation & Development Comm'n*, 461 U.S. 190 (1983). This admonition has particular force in this case, in light of the statutory reservation to the States of authority over production and gathering.[10] We agree with the appellant that the States may not, under the guise of that authority, attempt to regulate the interstate market. But the mere existence of contracts committing gas to the interstate market does not deprive the States of the ability to modify, for proper allocation or conservation purposes, the legal rules governing production and gathering.

In sum, this Court should not, on this record, attempt to resolve the preemption issue in the context of complex state regulations dealing with gas conservation and production, "as thorny a problem as has

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38a (dissent) with J.S. App. 6a (majority summary of effects of order change, noting principle of compensating drainage, leading to increase in allowables for underproducing wells, as tending "to keep the wells in balance in the long pull").

[10] In contrast, the state regulations at issue in *Northern Natural* and *Transco* are addressed directly to the actions of interstate pipelines, whose activities are comprehensively subject to federal regulation. While, for the reasons noted above, we do not believe this difference is in itself dispositive, it may well justify a somewhat more deferential approach to state regulatory attempts in the instant case.

challenged the ingenuity and wisdom of legislatures" (*Railroad Commission* v. *Rowan & Nichols Oil Co.*, 310 U.S. 573, 579 (1940)).[11]

CONCLUSION

For the foregoing reasons, the appeal should be held pending this Court's decision in *Transco*, No. 84-1076, and disposed of as appropriate in light of that decision.

Respectfully submitted.

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[11] Appellants' contention (J.S. 20-23) that the amended state rule is inconsistent with the Commerce Clause is based on the same contentions as to the effect of that change that underlie their preemption claim (page 9, *supra*), and would similarly be illuminated by further findings. If the rule change is invalid on preemption grounds, it is unnecessary to consider the Commerce Clause claim. Cf. *Middle South Energy* v. *Arkansas Public Service Comm'n*, 772 F.2d 404, 411 (8th Cir. 1985) (disposing of case on Commerce Clause grounds, rather than addressing preemption claims). But if the state action is acceptable regulation of production, an area reserved by the federal statute to the states, with only a permissible incidental effect on interstate commerce, the Commerce Clause challenge necessarily fails. See *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); *Champlin Refining Co.* v. *Corporation Commission*, 286 U.S. 210, 235 (1932).

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